Testimony

of the

National Grain and Feed Association

before the

Subcommittee on General Farm Commodities and Risk Management

House Committee on Agriculture

U.S. House of Representatives

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Good morning, Chairman Moran and members of the subcommittee. We appreciate the opportunity to present our views on the reauthorization of the CFTC and related risk management issues confronting agriculture. I am Tom Coyle, General Manager of Chicago & Illinois River Marketing LLC, in Chicago, Illinois, and I serve as Chairman of the National Grain and Feed Association's Risk Management Committee.

The National Grain and Feed Association is a U.S.-based non-profit trade association of more than 900 grain, feed and processing firms comprising over 5,000 facilities that handle more than two-thirds of all U.S. grains and oilseeds. Founded in 1896, the NGFA encompasses all sectors of the industry, including country, terminal and export elevators, feed mills, cash grain and feed merchants, livestock integrators, grain and oilseed processors and futures commission merchants.

Our industry, as the first purchaser of grains and oilseeds from producers, has traditionally provided both marketing and risk management services to farmers through a variety of cash contracts. NGFA's membership also represents a substantial portion of the hedge business volume on the grain exchanges, so we have strong interest in the performance of both futures and cash markets. In our testimony today we will address three broad issues: 1) Futures exchange performance and oversight by the CFTC; 2) Greater legal clarity for cash grain contracts; and 3) Producer risk management in an era with potentially lower government support for production agriculture.

Futures Exchange Performance and Oversight by the CFTC

The NGFA strongly supports reauthorization of the CFTC. The agency performs an important oversight and regulatory role that benefits the grain, feed and processing industry as a primary user of agricultural products on regulated exchanges. Our organization maintains a strong, professional working relationship with the CFTC, and we have been generally pleased in recent years with the leadership and direction taken by agency leadership.

U.S. futures exchanges are experiencing higher volumes of trading in both agricultural and other commodities. In accommodating this growth, the order entry and execution systems of the exchanges have at times been challenged during high volume, rapidly moving markets. On April 15, 2004, at the Chicago Board of Trade, NGFA members reported excessive delays in some orders being entered, order execution and in reporting fills of orders as well as some wide bid/offer spreads. Most of the problems seemed to be occurring with smaller-sized orders.

The NGFA contacted the CBOT, urging that the exchange give the execution and performance issues a high priority. Within two days, NGFA received a response from the CBOT president that outlined a number of specific measures the exchange planned to implement to resolve the matter. In December 2004, the CBOT reported to a meeting of NGFA member country elevator managers what it had done to implement changes. The CBOT will report again at the NGFA convention on March 31 concerning its implementation of changes and resulting market performance improvements.

We do not raise this issue here today to complain about futures market performance. To the contrary, we think it demonstrates the exchange being highly responsive to its customer base and taking the issues raised by hedger customers very seriously. In our view, all the grain exchanges – Chicago Board of Trade, Kansas City Board of Trade, and Minneapolis Grain Exchange – are actively reaching out to their customer base to receive feedback and respond to needs of market participants. These exchanges realize they are in a competitive world and are making serious effort to provide efficient, liquid markets that serve customer needs.

The 2000 Commodity Futures Modernization Act provided additional regulatory flexibility in the CFTC's regulation of exchanges in all commodities, except for the enumerated commodities (grains, and other agricultural commodities). We are not going to argue that the time has now come for enumerated commodity markets to be treated with the identical regulatory structure as all other markets. However, there is no doubt that greater regulation of enumerated commodity markets creates more hurdles to making rapid, adaptive changes to respond to perceived customer needs and adds to the cost of operating the exchanges.

Will this create cost-competitive challenges for U.S. exchanges in the future? The U.S. exchanges are in the best position to draw that conclusion. We do think it is to the advantage of the U.S. producer and consumer to have strong, liquid futures markets here in the U.S. to maintain marketing and pricing efficiency. Given the responsiveness of the exchanges to their customer base, we would submit that the agricultural markets should soon be candidates for a more flexible and less costly regulatory structure. The increasing competition in the marketplace tends to provide additional discipline that should eliminate some of the need for regulations under the CFTC.

Greater Legal Clarity for Cash Grain Contracts

The Commodity Futures Modernization Act of 2000 (CFMA) addressed a potentially major problem in non-agricultural off-exchange derivatives markets. It provided legal certainty for such derivative contracts to be legally enforceable after both parties had executed the contract. Because of the growth and growing economic significance of financial derivatives, this action was deemed necessary to give greater assurance of the ongoing performance of huge markets that underpin the functioning of the general economy.

While agricultural markets are considerably smaller than these financial derivative markets, cash agricultural contracts remain saddled with the risk that the CFTC or the court system may review a particular contract and declare after the fact whether the contract is viewed as legal (exempt from CFTC jurisdiction) or illegal, and therefore not enforceable.

We think it is important that the marketplace have more direction from government as to the legal standing for agricultural cash contracts. Increasingly, cash contracts that are offered to farmers have features that provide the farmer and the merchant with greater flexibility. That flexibility has value to both parties. Unfortunately, the flexible features that provide more value and utility are the same contract features that potentially raise questions regarding the contract's legal standing. Contract features such as providing for multiple pricing opportunities, allowing a contract to be rolled forward, and offering the ability to cash settle the contract have real economic value, but depending on the circumstances can raise legal questions. The bottom line is that we think greater legal clarity will provide the marketplace the ability to offer more value through cash contracting.

Since 1996, the most litigated legal issue regarding cash contracting was whether the rolling feature built into cash forward contracts made the contract illegal per se. The vast majority of the cases decided since 1996 found that rolling was a legal feature, but the message to the industry was clear: legal uncertainty creates litigation risk and litigation risk can be expensive. Even when you "win" you may have to pay legal fees of several hundred thousand dollars to prove the point.

There are two potential ways to resolve the need for greater legal clarity for contracts that are exempt from CFTC jurisdiction. One way is to amend Section 1a(11) to more crisply define exempt forward sales of cash commodities. The other method would be for the CFTC to develop more specific guidance for the cash marketplace that gives consideration to the most recent relevant cases before the CFTC and the Federal Circuit Courts. In our judgment, the latter approach – through a regulatory proceeding at the CFTC – holds considerable promise, given the progress that recent court and CFTC cases have made.

The NGFA sent a letter in January 2005 to Acting Chairman Sharon Brown-Hruska requesting that the CFTC undertake such action, and expressing our interest in participation. A copy of that letter was sent to other CFTC Commissioners. To date, we have received generally positive responses from the CFTC regarding a willingness to actively pursue greater legal clarity. Hopefully that process will be initiated soon. While we are not requesting legislative changes at this time, we would welcome the support and participation by Members of Congress or their professional staff in a CFTC effort to accomplish greater legal clarity through regulation.

We would commend the CFTC for making some progress in the last three years through several individual cases. The courts have also contributed to increased clarity, especially in two cases that were decided by the 7th Circuit U.S. Court of Appeals.

In the so-called Nagel II case, the 7th Circuit Court identified the following criteria as providing necessary and sufficient parameters for cash contracts to be declared fully legal and exempt from CFTC oversight and regulation:

1) The contract specifies idiosyncratic terms regarding place of delivery, quantity, or other terms, and so is not fungible with other contracts for the sale of the commodity;
2) The contract is between industry participants, for example farmers and grain merchants; and
3) Delivery cannot be deferred forever because the farmer must pay a fee for extending (rolling forward) the contract.

Furthermore, in the Zelener case, the 7th Circuit court found that the fundamental difference in futures and cash contracts was <u>not</u> the "delivery" feature (because both futures contracts and cash contracts call for delivery), but was in fact that the futures market essentially was "trading the contract" and the cash contract was trading an actual physical commodity. The Zelener case also raised the issue as to whether the original

CoPetro decision that established the "multi-factor" approach so often used by the CFTC was in fact an unnecessary extension of the law in that all that is necessary to find that a contract is exempt is to demonstrate clearly it is the trading of an actual physical commodity and not trading in uniformly defined contracts.

The NGFA's view is that a careful reading of these decisions, along with the decisions of the CFTC on cases concluded in late 2003, can lead to a much better understanding of a clear definition of cash forward contracts that are exempt from CFTC oversight. While we judge corrective legislation to be unnecessary at this time, some refinements of the existing statute could be in order if the regulatory process fails to achieve an adequate solution.

<u>Producer Risk Management: Lower Government Support for Farmers May Create More Need for Risk Management Tools for Producers</u>

As this subcommittee is keenly aware, government budget cuts and the negotiations coming up in the next round of the World Trade Organization could affect the level of government direct support to U.S. farmers. If this occurs, producers may find they have greater need for market-based risk management tools. Given this situation, it seems timely to at least review the market-based risk management tools now available to producers and to make note of regulatory barriers that are today restricting access for some producers.

Attached to this testimony is an appendix that provides an inventory of some market-based risk management tools, and offers some judgments as to why these tools may or may not be attractive to producers. Exchange based tools – futures and options markets – provide both a direct way for producers to manage price risk and the foundation for hedging a variety of cash contracts that are offered through merchandising companies. While a growing number of grain and oilseed producers are regularly utilizing exchange-based or cash contracting tools today, reductions in government programs that have traditionally protected against low price situations should create additional demand for such products.

As noted previously, modern cash contracts that are specifically tailored to producers' need for risk management and flexibility can be facilitated further by the CFTC providing greater legal clarity on what terms and flexibility are legally acceptable. Also, while we are not advocating specific changes in agricultural trade options regulations, we do think it is appropriate that Congress be aware of stipulations in current regulations that restrict access to trade options and similar products.

Agricultural trade options (ATOs) were granted regulatory approval in April 1998, but the CFTC rules made the program very expensive and cumbersome to any entity that might have considered becoming licensed under the program. Subsequent refinements have encouraged little participation, and thus far, only one firm is even registered for that program.

While the CFTC's ATO regulations did little to provide new risk management tools to farmers in general, they did have other implications. The rule specifically exempts producers with $10 million in net worth from any of the ATO regulations. Thus, any producer with a high net worth may have access to a range of potential new risk management tools that are unavailable to moderate-sized producers. While there is some logic to a high net worth being associated with market sophistication (and thus less need for CFTC oversight), given the potential value to producers, the level of restrictions on access to tools may be worthy of consideration.

Additionally, when the CFTC regulations were put into effect, they had a chilling effect on the agricultural swaps market. The exemption level for participating in all swaps markets (both enumerated agricultural commodities and other commodities) was originally set at a minimum of $1 million in net worth. The CFTC's agricultural trade options regulations "clarified" that the minimum net worth for agricultural swaps going into the future was revised, beginning in 1998, to a minimum of $10 million. This regulatory adjustment is known to have halted the use of certain agricultural swap contracts used to hedge price risks with some farm management companies.

Again, at this time, we do not make any specific recommendations on what is the right approach with the CFTC's regulation of trade options or swaps markets. But if, in fact, U.S. producers are confronting reductions in government support, there will be additional need for flexible risk management tools and, thus, a potential reason for reconsidering how either lack of legal clarity or existing regulations may restrict producer access to such tools.

<u>Summary</u>

To conclude, the NGFA strongly supports reauthorization of the CFTC. While we are not currently asking for major legislative changes, we suggest that a dialogue with the CFTC, and perhaps eventually with Congress, should begin to focus on three areas:

1) Futures exchange performance and oversight by the CFTC – and in particular, considering a potentially more flexible regulatory environment for U.S.-based exchanges with regard to agricultural contracts;

2) Greater legal clarity for cash grain contracts, with a view toward minimizing the litigation risk of companies working with producers on marketing strategies, and providing additional flexibility and marketing options for producers; and

3) Examining additional regulatory flexibility to aid producers in their risk management strategies in an era with potentially lower government support for production agriculture.

Mr. Chairman, we appreciate the opportunity to present our views on the CFTC and related risk management issues in agriculture. I would be happy to respond to any questions.

Appendix

Farmer Risk Management Tools: What's Available

The chart on the last two pages of this Appendix summarizes a number of the market-based risk management tools available to producers, including:

1) Exchange-based tools – futures, options;
2) Cash contracts (for crops) – fixed price, minimum price, and other;
3) Agricultural trade options.

A. Exchange-based tools. As the undisputed centerpiece of price discovery and price risk management in grain-based agriculture, exchange futures contracts remain the single most important tool and also provide the foundation for many other risk management tools. Virtually all cash contracts offered to grain farmers are designed so as to permit hedging the risk through exchange instruments. Thus, a high percentage of cash contracting activity establishes a price risk to the buyer that is ultimately "laid off" in futures markets.

Farmers may use futures markets directly to price products and hedge risk, and such tools have distinct advantages that are available only on regulated exchanges: 1) highly liquid markets allowing rapid adjustments in strategies, and are very cost-efficient; 2) guaranteed counter-party performance; 3) transparent pricing of the futures portion of cash price; and 4) mechanisms to price now or later and during periods of "carry" in the market, and to assure returns to farmers for grain storage activities. Exchange options require an up-front premium payment, but have the added feature of locking in an assured minimum futures price while giving the farmer an opportunity to participate in upward price swings. Options, unlike futures, do not require ongoing margining and the total cost is known in advance.

Why aren't exchange-based tools used by more farmers? With all the advantages that exchange-based products offer – many of which cannot be duplicated off-exchange – the question is often asked: Why don't more farmers use futures and options directly? The biggest disincentive to farmer use of futures has been the fact that past (and even some current) government programs contain features that give a free competitive alternative to exchange products. If government continues to deregulate commercial agriculture, there will be some growth in the direct use of futures markets by farmers, but there are reasons to expect the growth to be slow, at best: 1) The government loan rate continues as a free "put" option to the farmer; thus there is little need for the farmer to duplicate (and pay for) this position in the market unless prices are at a level moderately higher than the loan rate; 2) Futures markets only address the "futures" price portion of cash prices; basis levels (difference in central futures price and local cash price) remain a risk to be managed through the use of a separate tool (such as a basis contract); and 3) In the case of futures, the fact that daily "mark-to-market" occurs is beneficial in that the hedger knows his/her position every day, but the accompanying need to finance margin requirements which can be annoying, or a potential financial risk to protect a hedge in a rapidly changing market. Possibly the most significant disadvantage of direct farmer use is that futures only address a portion (albeit the most significant portion) of price risk.

B. Cash Contracts. In the grain and feed industry, cash contracts that are statutorily exempt from CFTC regulation have traditionally been used to: market physical grain; establish the price (both regulatory futures and basis); and manage price risk within a single product. The defining feature of "exempt" cash contracts (in contrast with regulated futures) is that physical delivery is required and generally occurs. <u>Fixed price cash contracts</u> give the farmer the ability to establish a firm cash price weeks, months, or even years ahead. (The ability to establish forward prices would be greatly impeded, if not impossible, without the existence of the futures markets that offer price quotes and a liquid hedging vehicle for delivery periods months/years in advance.) <u>Minimum price contracts</u> permit the establishment of a minimum cash price but allow the farmer to participate in upward movements in market prices prior to delivery. The <u>mini-max contract</u>, establishes both a minimum and maximum price, thus the farmer knows in advance the <u>best</u> and <u>worst</u> cash price that he can receive for a given crop. Why would a farmer want to set a maximum price? By being willing to "cap" upside potential, the farmer can effectively reduce the premium cost to establish a price floor.[1] The <u>basis contract</u> allows the farmer to establish a fixed basis (difference in futures and local cash price), but permit the establishment of the reference futures price at a later date (presumably when futures are more favorable).

The <u>hedge-to-arrive (HTA) contract</u> is the mirror image of the basis contract: it permits the establishment of a futures contract reference price, and allows the farmer to set a basis level at a later date. Both the basis contract and the HTA are designed to offer "a la carte" marketing flexibility to the farmer – to be able to set futures and basis levels at separate times during the marketing year in an effort to "optimize" both components of the cash price. The <u>delayed price (DP) contract</u> is shown in the table to demonstrate that not all contracts have risk management features. The DP contract is used to transfer title and provides an alternative to storage. It contains no risk management features for farmers.

Why don't more farmers use forward cash contracts? Farmers use cash contracting more frequently than they directly use futures products. There are two principal reasons for this: 1) The ability to do business with someone "local" (the

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[1] *The mini-max contract provides a good example of how various risk management services can be bundled to provide a fairly sophisticated and useful risk management tool, but one which is also readily understandable by the farmer. From the farmer's standpoint, a mini-max contract is straightforward: For a pre-established fee, the mini-max sets a fixed range of possible market prices for his/her crop. However, from the elevator's standpoint, this contract requires the bundling of the following services: 1) hedging futures risk which may entail three simultaneous transactions in futures and options markets [sell futures, buy a call (to establish minimum futures) and sell a call (to establish maximum futures)]; 2) management of cash basis risk; 3) management of financial risk (maintaining financing on the futures position); and 4) providing a physical delivery location for the commodity. Clearly, this bundling of services, and making the "risk profile" of the contract easy to understand by the farmer improves the likelihood that prudent risk management activities will be utilized.*

counter-party risk inherent in cash contracts, which is not present in futures, seems generally insufficient to offset this "local" market advantage); and 2) Cash contracts can provide a more complete risk management/marketing product through a bundling of services. (The most popular product – fixed price forward contract – addresses physical commodity marketing and establishes cash price – both futures and basis. It also includes financial services of margining the account and credit cost exposure.) Even so, farmers do not make as frequent use of forward cash contracts as might seem prudent. One likely reason for this is the requirement to deliver. In the event of crop failure, the farmer's obligation to physically deliver remains in place. This is one of the reasons that many farmers that use cash forward contracts also may use crop insurance tools like MPCI or CRC to assure a minimum level of capacity to acquire physical bushels to be delivered.

C. Agricultural Trade Options: Agricultural trade options (ATOs) are not being widely offered today as only one firm has signed up to provide ATOs under CFTC regulations.

Agricultural trade options are defined here as contracts that establish the right, but not the obligation to deliver a physical commodity, and which can be cash settled at or prior to expiration. The primary feature differentiating an ATO from traditional cash contracts is that there is a clear option for not executing on delivery of the commodity. In agriculture, given the nature of weather risk, the right to "walk away" from delivery for a defined price (the option premium) could be beneficial and could encourage earlier season and more aggressive forward contracting by producers even when the exact size of the producer's crop is unknown.

Summary of Major Risk Management Tools for Grain/Oilseed Producers

	Risks Being Managed	**Advantages**	**Disadvantages**
I. Exchange tools Exchange Futures	– Price Risk: (futures portion only)	– Liquidity – Daily mark to market – Guaranteed counterparty performance – Central price discovery – Allows assured market earnings for storage	– Addresses only futures prices – Margin calls in rapidly changing market (potential financing risk)
Exchange Put Option (set min futures prices)	– Price Risk: (futures price only; limits downside risk)	– liquidity – ability to cash settle; access to additional time value upon liquidation – no counterparty	– addresses only futures price risk
II. Cash Contracts Fixed Cash Forward	– Price Risk: futures and basis risk	– Ability to lock in firm cash price (futures and basis)	– Risk of unexpected large yield loss (required to deliver whether physically produced or not) – Perceived opportunity cost (contracted too early in uptrading market) – Counterparty risk
Minimum Price Contract	– Price risk; futures and basis risk – Limited yield risk management	– Sets minimum price but seller benefits from market rallies	– Counterparty risk – Risk of unexpected large yield loss
Mini-max	– Price risk; futures and basis	– Sets minimum and maximum price	– May limit upside market prices
Basis Contract	– basis risk only	– Permits establishing basis level and futures price at different times (flexibility to attempt to optimize total cash price)	– Leaves the most sizable portion of price risk (futures) open to declines – Counterparty risk

	Risks Being Managed	**Advantages**	**Disadvantages**
Hedge-to-Arrive (HTA)	– Futures (virtually equivalent outcome to short futures position)	– Permits establishment of futures & basis at different times – No margin calls	– Counterparty risk – Risk of unexpected yield loss
Delayed Price (DP)	– Manages no risks	– Logistical tool that provides alternative to storage	– Counterparty risk
III. <u>Agricultural Trade Options (ATOs)</u>	– Price (futures and basis) – Yield – Logistical	– Assists the producer in managing yield risk	– Counterparty risk – Regulatory burden on ATOM – Smaller farmers may be unable to participate ($10 million net worth to be exempt)